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LAND CREDIT.

It is a matter that may well awaken surprise that while Germany, Austria, France, and other European countries have had an organized system of land credit for a hundred years past, no similar attempt has been made in this country. Indeed, no steps looking to such an end have been taken by any of our legislative bodies. The fact is all the more remarkable in view of the large and rapid development of our system of commercial banking. The agricultural industry of the United States is of the greatest national importance; the benefits to be derived from an organized land credit by this industry are very great; the lack of such an organization is an obvious and serious handicap to the industry; and yet the development of our banking system shows this anomalous deficiency as compared with our rivals in the market.

Land credit does not differ greatly from commercial credit, except as regards the length of time for which loans are made. The borrower of a commercial bank generally turns over the capital secured in a few weeks or months, while the agricultural borrower ordinarily invests the borrowed capital in land or improvements that do not return the principal in a lump sum or a short term. His investment returns to him in annual installments extending over a considerable period. Consequently, any system of credit, such as that in vogue in this country, in which repayment of the principal in a lump sum is required, tends to embarrass the land-holding borrower.

The hardships of the American borrower may be well illustrated by a comparison with the methods in use in other countries, where a national land credit has reached its highest development.

There the medium of exchange between borrowers and lenders is a regularly organized mortgage bank, operating under

strict government supervision, with ample capital and reserves, and assuming full responsibility for the proper working of its business and the prompt fulfillment of its obligations.

These mortgage banks advance money upon pledge of real estate for periods of from ten to seventy-five years at the option of the borrower. The loans are contracted to be paid, not in one sum at one time as with us, but by small annual payments on the principal debt, called "amortisements," which are so calculated as to extinguish the debt at the end of the term. For example, upon the basis of its present operations, the annual charge of the Preussische-Hypotheken-Actien-Bank for a loan of \$1000, payable in fifty-seven years, would be $4\frac{1}{2}$ per cent. or \$45 per annum—interest being calculated at the rate of 4 per cent. and the annual installment or amortisement at $\frac{1}{2}$ per cent. The process of amortisement would then work out as follows :

FIRST YEAR.

Interest at 4 per cent. on \$1000 for one year,	-	\$40.00
Balance of annual payment applied on principal,		<u>5.00</u>
Annual payment,	- - - -	\$45.00
Balance of the principal debt due at the end of the first year,	- - - - - - - -	\$995.00

SECOND YEAR.

Interest at 4 per cent. on \$995 for one year,	-	\$39.80
Balance of annual payment applied on principal,		<u>5.20</u>
Annual payment,	- - - -	\$45.00
Balance of the principal debt due at the end of the second year.	- - - - - - - -	\$989.80

By continuing this process for fifty-seven years the effect of the annual decrease in the interest charge, and the consequent increase in the amount applied to the reduction of the principal debt, is to cancel it at maturity.

In addition to the above conditions the borrower is given the privilege of reducing the debt as much faster as he finds it in his power to do. The extent to which this privilege is taken

advantage of is best illustrated by the experience of the Credit Foncier of France, which, in lending a total of 4,281,668,816 francs since 1852, has been repaid in anticipation of maturity to the amount of 2,504,299,094 francs.

The mortgage bank gets the funds for the loans by issuing and selling its bonds or obligations, bearing a stipulated rate of interest, running for a length of time equal to or greater than that of the loans securing them, and redeemable by the bank at its option before maturity. These bonds, being the direct obligation of the bank, are absolutely guaranteed by it as to prompt payment of interest and principal and are listed for purchase and sale upon all of the principal continental exchanges. Their popularity as investments among all classes is evidenced by the fact that the present outstanding issue of the German mortgage banks, amounting to about 6485 million marks, bears an average interest-rate considerably below 4 per cent. while the average rate paid upon the outstanding issues of the Credit Foncier (amounting to over three billion francs) is less than 3 per cent.

Every year, at designated periods, the funds accruing to the mortgage bank through regular and anticipated payments upon its loans are used to redeem and retire a corresponding amount of its outstanding obligations, in accordance with the government statute which requires of the bank that such outstanding issue of obligations must never exceed in amount the value of its loans. As will be seen from the foregoing illustration of the amortisement process, the amount applicable to the redemption of obligations at the end of the first year would be at least 5 per cent., at the end of the second year 5.2 per cent., and these percentages would be increased by whatever amount had been paid upon loans by anticipation. One of the best and strongest features of this system is that while the obligations of the bank in the form of bonds are being retired in increasing amounts each year, the security for its loans is continually augmented by reason of the annual payment made upon each debt.

Such in brief is the European system of extending credit to

landholders as it has been carried on for over one hundred years, withstanding the tests of war, panic and political disturbance in such a manner as to afford the most convincing proof of the soundness of the principles upon which it is based and contributing year after year to the economic welfare of the countries which have adopted it.

If we imagine for the moment the condition of affairs that would be most likely to follow the repeal of all legislation pertaining to our state and national banks, leaving them free to act without any restriction or supervision, we will have a very fair idea of the present status of that business which with us takes the place occupied in Europe by the mortgage banks. The lack of any legislative provision for the establishment of these banks in the United States to act as the means of communication between borrowers and lenders, in the same manner as our commercial banks now do, forces the business into a form of brokerage. An individual lender and an individual borrower are brought into communication by an agent who generally assumes no financial responsibility and whose interest ceases, as a rule, when the formalities of negotiating the loan have been completed, the money paid to the borrower and the commission secured.

It is to this relation of individual borrowers to individual lenders that most of the evils of our present methods may be traced. Principal among these evils are the following:

Inequality in the distribution of capital for lending purposes.

Excessive interest charges in comparison with other countries.

Inadequate provision for the manner of repaying the debt.

A form of investment security not readily convertible into cash, and not available for the safe investment of small sums of money.

Inequality in the distribution of lending capital in the United States is very noticeable when comparison is made with European countries. Investment funds are continually accumulating in the older and wealthier states at times when they could be

used with advantage and profit in the development of the newer and less wealthy ones; and yet it is only with the greatest difficulty that this capital can be induced to move from one point to another. This disinclination of money to move where most needed arises almost entirely from the lack of a proper land credit system, such as would be provided by mortgage banks. With the permanent and responsible character which these institutions possess, and with the additional safeguards, coming to investors through strict supervision by the government, they would easily attract the needed capital for loans by means of a slight advance in the rate of interest; whereas under the present system an advance of anywhere from 1 to 3 per cent. must be offered to obtain the same result.

The loan agent or broker from whom loans must now be procured has, at the best, little more than a local reputation for honesty and responsibility, and hence he must rely largely upon his own immediate neighborhood for a supply of lending capital—the effect being to render the making of loans in the United States essentially a local business. It is not strange, therefore that as we travel westward into the younger and less wealthy states we find the rate upon real estate loans constantly increasing. Thus, for example, Massachusetts shows in the last census report an average interest rate of 5.51 per cent, New York 5.53 per cent., Ohio 6.55 per cent., Indiana 6.88 per cent., Illinois 6.78 per cent., Missouri 7.80 per cent., Kansas 8.83 per cent. In the North Atlantic States the average rate of interest charged upon farm mortgages is shown to be 5.8 per cent, while the Middle Western states show an average of 7.5 per cent. And yet it can hardly be argued in explanation of this difference that the former lands afford better security than the latter, which include a territory that for general fertility is not surpassed in the world.

Excessive interest charges are due partly to this inequality in the distribution of lending capital, but principally to the fact that mortgage-investment securities are not readily negotiable. In this they are at a disadvantage as compared with securities

for which there is a ready market on some exchange. There is no reason why the obligations of American mortgage banks, based upon real estate security and further secured by the capital of such banks, should not be listed, bought and sold in exactly the same manner as are government and railroad bonds in Wall street. This is done daily in Paris, Berlin, and Frankfort by the European banks, and has been done for many years with such success that some German banks have successfully marketed obligations in which no date is set for payment.

The Credit Foncier of France issues two kinds of mortgage bonds—communal and foncière; *obligations communales* being issued against municipal security, and *obligations foncières* against the pledge of real estate. Of these, the last issue of *obligations communales* (that of 1892) was subscribed to the amount of 250 million francs and bore interest at the rate of 3 per cent. per annum, while the last issue of *obligations foncières* put out in 1895 amounted to 250 million francs and bore 2.8 per cent. interest. That these bonds are regarded by French investors as securities of the highest grade is evidenced in the fact that on the last day of the year 1897 the records of the Paris Bourse show sales of the *obligations foncières* at a figure making the net interest return 2.84 per cent., while upon the same day the 3 per cent. *rentes* of the French government sold upon the less favorable basis of a return of 2.91 per cent. per annum. The United States government bonds of the recent 3 per cent. loan are now being dealt in at a premium making the net interest return upon them slightly less than that rate, while the best class of American railroad and municipal bonds sell at present on a basis of about 3.5 per cent. It is evident from the above that the supply of investment funds in this country is obtainable on first-class security at rates not greatly in excess of those current in France. It is therefore not an unreasonable assumption that if mortgage bonds could be made as attractive in the United States as they are in France (a thing which is entirely practicable), they would soon meet with quite as favorable a reception as they did at the time of their introduction into that country.

A reduction of as much as 2 per cent. per annum in the interest rate charged to borrowers was effected in France within a few years after the introduction of this class of bonds, and they should soon be marketable in this country on as good or better terms than the best class of municipal and railroad securities.

Individual mortgages are not of a uniform character, and they can therefore never be made quickly negotiable, and can therefore not secure the more favorable terms that are accorded to securities which may be quickly converted into cash. Hence it is not probable that any great relief will be afforded to American borrowers in the way of decreased interest rates until the present system makes way for a better one.

It is the manner of payment provided in the case of mortgage indebtedness that involves the greatest hardship to borrowers in this country. The usual term of a mortgage is arbitrarily set by custom at five years—a practice that has probably arisen from the difficulty in converting mortgage securities. This difficulty of conversion makes the lender disinclined to tie up his funds for a longer time. It would be difficult to say just what the actual average life of our real estate mortgage debt is, but that it is considerably over five years is unquestionably true. The census of 1890 gives the average life of an Illinois mortgage as 4.81 years, but in arriving at this result one very important feature of the calculation had, of necessity, to be omitted. Not every mortgage released of record represents a debt paid out of the borrower's own funds, but more frequently it indicates another loan contracted elsewhere. The average life of Illinois mortgages is probably much nearer ten years than five—a calculation that is checked in some degree by the experience of all large lenders to the effect that of one hundred loans maturing, from forty to fifty will seek renewal. Moreover, it is to be noted that this increase in average life of mortgage debts has taken place during a period of high prices for products, such as will probably not rule in the future. This practice of making mortgages mature within a period that experience shows to be about one-half the ordinary needs of the debtor is unjust in that it forces

the borrower to make new terms with the lender every five years, and often at times when, by reason of financial or political disturbances, he must do so at considerable expense and an increased rate of interest due to a temporary advance in the current rate.

Another reprehensible practice is that of making the mortgage debt payable in a single sum and on a certain date—a practice which, if designed for the purpose of discouraging debt-paying, could hardly have been improved upon, being totally at variance with the conditions under which the debtor works. Statistics show that of the real estate mortgages made in the United States, fully 80 per cent. are incurred for the purchase of land, presumably by those who expect to pay off the indebtedness out of their surplus earnings. The farmer in the country and the homemaker in the city have as a rule little or no opportunity to use small sums of money for short times in a manner that will return to them the rate of interest which they are paying on the mortgage, and not being able to apply such sums to the reduction of the debt, they must either lose interest upon them during the period of accumulation or deposit them in some local bank where they earn from 2 to 4 per cent. less than the mortgage bears. It is true that recently there has been some disposition on the part of lenders to take cognizance of this fact and to allow prepayments to be made; but inasmuch as the forced acceptance of possible small sums of money at unlooked-for periods is an inconvenience to the lenders, it is not probable that this custom will ever become very general.

In the manner of paying the mortgage debt, the practice of the European mortgage banks could not well be improved upon. The life of the loan is made for a sufficiently long term to cover all contingencies adversely affecting the borrower; the annual payment is so small as to be hardly felt, and yet if persisted in it will cancel the debt; while no obstacle is raised against the payment of the obligation as much faster as the borrower may be able to make it. The system is equally advantageous to the lender. He finds himself in possession of a readily negotiable

security which can be procured in large or small amount, according to his demand, and which, when paid, is paid in full.

If for no other reason, the magnitude of these mortgage banks should command our attention. Thirty-four joint stock corporations listing their bonds on the exchange at Frankfort had, in 1896, a paid-up capital of 112 million dollars, or an average of over three millions apiece. The capital and surplus of the Credit Foncier of France amounts at the present time to 40 million dollars.

The remarkable freedom from violent fluctuation of mortgage bonds has been evidenced on many occasions. From 1879 to 1893 the 4 per cent. issue of the Bavarian and Hypotheken and Wechsel Bank never declined in the open market below 97.75, and rose as high as 102.5; and since 1885 the $3\frac{1}{2}$ per cent. issue of this bank has fluctuated between 95.5 and 99.25, an extreme range of only 3.75 points. From 1808 to 1816 the mortgage bonds of the Silesian Landschaft fell as low as 58 during Napoleon's campaigns, but since 1816 the 4 per cent. bonds of this society have never declined below 99.75, and have generally ruled at about 105.

There is a prevailing belief in the United States, left as a legacy by numerous so-called "investment companies" which flourished for a time in the West, that bonds based upon real estate mortgages cannot with safety be guaranteed by an intermediate corporation standing between the borrower and the lender. They certainly cannot, as experience proves, if the business is conducted in a careless, ill-advised, and oftentimes dishonest manner, or even where it is carefully conducted but without regard to the principles involved in the proper use of land credit. But if the principles of the business are recognized from the start and the management of the corporation is conducted with the same care and foresight that is given to any large financial concern, such bonds may be absolutely guaranteed as to prompt payment of interest and principal, with every reasonable assurance that such guarantee will prove good. There is a great difference between the practice of guaranteeing bonds

based upon mortgages that are made to run for an inadequate length of time and the guaranteeing of those which are secured by mortgages running for a length of time sufficient to cover all contingencies, payable in small annual installments, and thus giving to the borrower ample opportunity to discharge the debt in a gradual and easy manner out of his annual surplus earnings. When American farmers, living in good productive localities, are unable to pay reasonable interest on a proper loan and the small additional installment on the debt necessary to cancel it in from thirty to fifty years, there will be little hope left for anything else in the way of investments.

The mortgage bank stands between the borrowers and the lenders, as a responsible intermediary assuring to the former an ample supply of funds for loans upon proper security at reasonable rates, and to the latter the exact and regular service of the interest and principal payments due upon its obligations in their hands. It lends, as a rule, not over 50 per cent. of a fair valuation of the real estate offered as security, appraising the value of that real estate from the double standpoint of selling value and net annual return. It completes all formalities connected with the process of mortgaging, and when these are completed it issues and sells its mortgage bonds to the same amount. All interest overdue and unpaid is advanced by the bank, all foreclosures are undertaken and prosecuted by it, and all real estate acquired in its operations is carried by it until sold.

It will thus be seen that the principal demands made upon the capital of the bank arise in these last mentioned instances, so that in considering the probable success of such banks in the United States, the question of chief interest is to determine whether conditions in this country are such as to result in the same relative percentages of default and foreclosure that are met with in other countries. To determine this, the best data for comparison are those afforded by the experience of life insurance companies which have been for many years large lenders upon real-estate mortgages, and which have, as a rule, selected their loans with a degree of care and experience

similar to that shown in the management of the mortgage banks.

The *Ætna Life Insurance Company* of Hartford, Conn., loans largely upon improved farm lands, and has probably placed more money on that class of securities than any other company. Its report to the insurance commissioner in 1896 shows real estate acquired by foreclosure to the extent of seven-tenths of 1 per cent. of its outstanding loans—the outstanding loans amounting to 25 million dollars. The *Northwestern Mutual Life Insurance Company*, another large lender, with loans of over 66 million dollars, shows real estate acquired by foreclosure representing about 1.6 per cent. of its total loans; while the combined statement of the seven largest companies loaning upon both farm and city real estate shows an average of 6 per cent. acquired by foreclosure out of the total outstanding investment. Omitting one of these companies, the percentage is reduced to 3 per cent.; which figure more nearly represents the normal percentage that might be reasonably counted upon under good management. As compared with these percentages the *Credit Foncier* shows real estate acquisitions representing an average of 1.6 per cent. of all its loans—a result less favorable than the first-mentioned company, no better than the second, and not greatly differing from the combined statement of the six above referred to.

As regards the comparative promptness with which interest collections are made in this and other countries, the records of one American lending institution, which covers a period of fifteen years, and represents the collection of over 5.3 million dollars interest, shows that 97.1 per cent. of all interest maturing was paid within ninety days after maturity, and that the highest percentage of unpaid interest at the end of ninety days in any one state for any one year was 7.2 per cent. The report for 1896 of one of the large insurance companies above referred to shows that of all interest that matured during that year only 4 per cent. remained unpaid at the end of it, while the combined statement of the seven companies shows 11 per cent. unpaid. This calculation proceeds on the supposition that their mortgage

investments netted an average of 6 per cent. per annum. If the average interest rate be placed at $5\frac{1}{2}$ per cent., which is probably nearer the fact, the percentage of overdue interest would be reduced to a lower figure. For comparison with these percentages, the overdue interest of the Credit Foncier can only be obtained approximately, for the reason that the payments to it are made up both of principal and interest, and cannot be separated into their elements, but it is certain that of all interest due during 1896 more than 10 per cent. remained overdue on March 1, 1897—a showing not as favorable as that which could probably be made by any one of the above-mentioned companies.

Obviously, therefore, all of the conditions requisite to the success of American mortgage banks now exist in this country, with but one exception. There is no proper restrictive legislation and no provision for the supervision of their operations in such a manner as will invite the confidence of investing classes to them. Without such restriction and supervision it will at all times be possible for them to lend, if so disposed, upon insufficient security and to continue the practice until forced into liquidation. Such supervision can best be exercised in the same manner that now is exercised in the case of national and state banks. And, in all probability, many lending institutions now operating under great disadvantages would hasten to place themselves under such supervision; so that it may fairly be said that the only thing lacking to secure for the United States the benefits obtained by European nations from their system of land credit is the careful attention of the legislature.

OREN TAFT, JR.

CHICAGO.